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COLOMBO 00000321 001.2 OF 034

¶1. THE FOLLOWING IS THE INVESTMENT CLIMATE STATEMENT
FOR SRI LANKA FOR 2006.

INVESTMENT CLIMATE STATEMENT SRI LANKA

February 2006

CLAIMED OPENNESS TO FOREIGN INVESTMENT; REALITY DIFFERS
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¶2. Over the past two years, Sri Lanka has begun to change course economically and is heading in a more statist direction. It has shown significantly less interest in economic reform and the privatization of loss-making state-owned enterprises than previous governments and has apparently decided not to pursue a program with the International Monetary Fund (IMF), which, along with the World Bank, has provided budget support in the past. On the trade front, Sri Lanka had played an active and productive role in the WTO Doha Round, up to the Cancun Ministerial in June 2003. More recently, however, Sri Lanka has taken a much more defensive posture in the WTO and has instituted a number of import and export fees and para-tariffs that have increased the cost of trade. While the economy continues to grow, inflation and a depreciating currency are deteriorating purchasing power. The recently elected Government of President Mahinda Rajapakse has not taken significantly different stances economically from the previous Government headed by President Chandrika Kumaratunga, but both have been more statist in their approach to the economy than the government that ruled from 2002-2004. Since the implementation of the cease-fire in early 2002, Sri Lanka has seen increased interest on the part of

potential foreign investors, but the on-again, off-again nature of the peace process has tended to depress the overall flow of funds into the country.

--Historic Progress; Conflictive History

¶3. Sri Lanka?s economic growth over the past decade averages 4.6 percent annually. The country has traditionally boasted unique human development achievements for a developing country although it has seen some of its neighbors surpass its earlier achievements. Sri Lanka's per capita income of USD 1,100, a literacy rate of over 90 percent in the local language, and life expectancy of 72 years rank well above those of India, Bangladesh and Pakistan, yet fall behind other neighbors such as Singapore and Thailand. It is generally acknowledged that English ability has declined significantly since the 1970s. While Sri Lanka?s progress in achieving UN Millennium Development Goals (MDGs) compared to its South Asian neighbors is commendable, Sri Lanka needs to address several issues in meeting the MDGs by 2015. These include disparities in achievement at sub-national levels and reducing poverty (23 percent according to the official poverty line for Sri Lanka).

¶4. The 20-year ethnic conflict between the U.S. designated terrorist organization Liberation Tigers of Tamil Ealam (LTTE) and the Government of Sri Lanka (GSL) has been widely recognized as a key impediment to development and as an obstacle to foreign investment. A Norwegian-brokered cease-fire between the LTTE and the government, in effect since February 23, 2002, continues to hold despite the LTTE withdrawal from peace talks in April 2003 and continuous tit-for-tat killings between LTTE members and anti-LTTE

paramilitaries, hartals by Muslims and Tamil communities in the east and the August 12 assassination of Sri Lanka?s Foreign Minister, among other factors. After a rapid escalation in violence immediately following the election of Mahinda Rajapaksa as President on November 17, 2005, the GSL and LTTE agreed to meet in Switzerland on February 22 and 23 for talks to strengthen the ceasefire. There does not seem to be an appetite on either side for an immediate return to full-scale hostilities, but increasing violence, particularly on the part of the LTTE, is a worrying trend. Despite cease-fire violations, however, the peace process had substantially improved the political, economic and investment climate and initially resulted in attracting substantial funding from multilateral and bilateral donors to rebuild the country. The lack of recent progress on the peace front as well as difficulty in facilitating rapid reconstruction, however, has led to concerns that donor money for reconstruction may be diverted to other countries. Investment interest has also waned in the last year.

--December 26, 2004 Tsunami

¶5. The December 2004 tsunami caused extensive damage to life and property, affecting Sri Lanka?s economic performance. Approximately 32,000 people were killed, another 6,300 are missing, and 443,000 people were displaced. A joint damage and needs assessment by the key donor agencies estimated the overall damage to Sri Lanka at around USD 1 billion, with a large portion of losses concentrated in the housing, tourism, fisheries and transportation sectors. Major export sectors were not affected. Some of the worst destruction was in areas under LTTE control. An agreement on coordinating tsunami aid signed between LTTE and Government

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representatives in June 2005 (known as Post-Tsunami Operational Management Structure (P-TOMS)) was challenged in court and has never been implemented. According to post-tsunami assessments, Sri Lanka needs approximately USD 1.5 billion to implement a reconstruction program. After one year, Sri Lanka has completed the construction of 53,000 transitional shelters and is well into its permanent housing program with approximately 20,000 units completed. The entire rebuilding program will likely last three to five years.

--Leadership Changes

¶6. Since independence, the rule of government has alternated between the two major political parties, the United National Party (UNP) and the Sri Lanka Freedom Party (SLFP), or coalitions led by them. Both the UNP and the SLFP generally support open and outward looking economic policies. However, some coalition partners have thwarted such policies, leading to a failure to embrace consistent economic reform policies. This political complexity has sent confusing and inconsistent messages to investors and donors.

¶7. A Presidential election was held in Sri Lanka on November 17, 2005. Former Prime Minister Mahinda Rajapaksa of the SLFP, backed by the Marxist-Nationalist Janatha Vimukthi Permuna (JVP), the Buddhist monk-based Jathika Hela Urumaya (JHU) and some other minor parties was elected President, narrowly defeating Opposition Leader Ranil Wickremesinghe of the UNP. Rajapaksa had been Prime Minister in former-President Kumaratunga?s government, which took over following general elections in April 2004. In those elections, Kumaratunga aligned her party with the JVP

to form the United People?s Freedom Alliance (UPFA). Later, the JVP quit the Government to protest the coordination agreement (P-TOMS) between the Government and the LTTE.

--New Economic Policies

¶8. While Rajapaksa?s tenure is quite young, his broad economic strategy was outlined in his election manifesto ?Mahinda Chintana? (Mahinda?s Thoughts) and used for development of the 2006 Government budget. Mahinda Chintana loosely follows the previous government?s Economic Policy Framework ?Creating Our Future, Building Our Nation? (http://www.treasury.gov.lk) which focused on developing the small and medium enterprise sector (SME), agriculture and infrastructure, with a heavy reliance on government intervention in markets. Rajapaksa?s policies also have a heavy focus on poverty alleviation and redistribution of economic gains to disadvantaged areas. The Government rejects the privatization of state enterprises, including ?strategic? enterprises such as state-owned banks, airports, and electrical utilities. Instead, it plans to retain ownership and management of these enterprises and make them profitable. At the same time, it is taking steps to further expand the already enormous civil service. The previous government created three new agencies intended to improve state-owned enterprises: The Strategic Enterprises Management Agency (SEMA), the National Council for Economic Development (NCED) and the Procurement Management Agency. It appears the current Government will retain these institutions.

¶9. The 2006 budget, presented to Parliament in December 2005, increased corporate and personal taxes and other indirect taxes. These taxes are in addition

to prohibitive new taxes on the acquisition of land by foreigners (except foreign investors meeting certain criteria) and a new import fee on a range of consumer goods and non-essential items introduced in 2004. These additional taxes on imports go against the liberal trade regime once followed by Sri Lanka. An ?Economic Service Charge? (ESC) tax, ranging from 0.25 percent to 1 percent of turnover depending on the type of business, applies to all companies with turnover exceeding Rs 50 million (USD 500,000), including those currently benefiting from tax holidays. Companies already paying income tax will be able to offset the new tax against their income taxes. Nevertheless, for some companies, especially foreign investors which have tax holidays, it will be an extra financial burden. The private sector is also concerned about a government initiative to mandate specific wage increases for private sector workers.

¶10. On a positive note, the government has acknowledged the vital role that both foreign and local private investors play in the economy. Tax holidays have been offered to industries that set up outside the Colombo and Gampaha Districts in the Western Province in addition to tax holidays and other incentives already offered to investors by the Board of Investment of Sri Lanka. In addition, the budget also identified a list of infrastructure projects to be developed in the next few years.

--Economic Statistics

¶11. The economic situation in Sri Lanka in 2005 was remarkably stable, considering the huge potential

impact of the 2004 tsunami. The Tsunami?s overall economic impact appears to have been less severe than originally feared. Growth is expected to remain above 5.5 percent in 2005 and 6 percent in 2006. Part of the adverse impact on growth was offset by the reconstruction effort. Also, tourism and fishing, the two industries most heavily affected by tsunami, comprise a relatively small share of overall GDP. While inflation rose significantly in the months following the tsunami, it has begun to moderate, and fell to around 11 percent (from a high of 16 percent) in December 2005. Monetary policy has continued to be looser than forecast by the Central Bank and interest rates have been held artificially low in comparison to inflation.

¶12. Foreign investment remained stagnant, below USD 150 million in 2005. External trade was quite robust: exports rose by 10 percent and imports by 14 percent during the first ten months of 2005. Due to higher imports, the trade deficit has increased 25 percent to USD 2.1 billion during this period. The Government is trying to minimize the fiscal impact of the reconstruction program by seeking foreign assistance. Meanwhile, the GSL accepted a Paris Club offer by industrialized countries, including the US, to freeze its debt payments until the end of 2005. This released approximately USD 300 million from the regular budget (currently allocated for debt repayment) for reconstruction. In addition, the IMF has provided an emergency loan of about USD 159 million to Sri Lanka. The World Bank and the ADB have also pledged both grant and loan assistance. Due to the debt moratorium granted by several donors, a USD 100 million syndicated loan raised by the Government in December, and increased remittances by Sri Lankan workers abroad, the overall Balance of Payment (BOP) is projected to record a surplus of around USD 500 million in 2005. This is a strong contrast to Sri Lanka?s USD 200 million deficit in 2004. Total reserves increased to USD 4.1 billion

as of October 2005 from USD 3.4 billion in December 2004 and were sufficient for 5.5 months of imports. The rupee strengthened in early 2005 because of speculation on aid flows for post-tsunami reconstruction. However as aid flows began to moderate and the underlying inflation concerns continued, the rupee began to depreciate in late 2005. According to the Central Bank, due to the higher nominal growth in the GDP, the outstanding debt stock is estimated to decline to 98 percent of GDP by end 2005 from 105.5 percent at end 2004.

--Public Finance

¶13. Weakness in public finance is a key worry. Government fiscal control deteriorated in 2004-2005. Both the new government and the previous government focused on a larger government and increased welfare spending. Although, the government attempted to rein in the fiscal deficit by revising petroleum prices upwards, and removing a costly subsidy on wheat flour, these moves were insufficient to offset rising import prices. Numerous subsidies continue, including those for petroleum, electricity and fertilizer. Several private and public sector players in these sectors have suffered financial losses due to government?s failure to pay the required subsidy costs or to allow price increases in a timely manner.

¶14. The 2006 budget envisages a deficit of 9.1 percent of GDP. Tsunami expenditure will account for about 1.8 percent of the deficit and will be financed largely by

foreign grants and loans. The budget focuses on reducing poverty through assistance to farmers and development of the agriculture sector, increasing welfare benefits to poorer sections and on higher spending for public infrastructure. It also includes significant increases in government employment and public sector wages. The Government will hire 10,000 new graduates in 2006, in addition to about 42,000 hired in 2005, in an effort to stem unemployment, thereby expanding public sector employment by about 5 percent. As previously explained, the Government is trying to boost tax revenues through increased direct and indirect taxation. The Rajapaksa Government has expressed a desire to maintain macroeconomic stability (albeit at a delayed pace), and put fiscal reforms in line with the policy outlines of the Fiscal Management ?Responsibility? Act, which has a deficit and debt reduction plan over the medium term.

--Sri Lanka Obtains Sovereign Ratings

¶15. Sri Lanka received its first sovereign ratings on December 8, 2005. Fitch Ratings assigned Sri Lanka a ?BB-minus? rating (sub-investment grade) noting that all the long-term rating outlooks were stable. Standard and Poor?s rating was slightly lower at ?B-plus?. The sub-investment grade ratings were related to continuing uncertainty surrounding Sri Lanka?s political situation, the peace process and the relatively high budget deficit. The rating agencies commended Sri Lanka?s resilience to adverse shocks, strong institutions and an unblemished debt service record. Analysts widely expect Sri Lanka to use the rating to seek capital on the international market at better rates than the prevailing 11 percent domestic rate. The GSL would possibly use the ratings to pursue a foreign bond issue.

--IMF Programs No Longer Being Pursued

¶16. In 2003, the IMF approved a three year Poverty Reduction Growth Facility (PRGF) and an Extended Fund

Facility (EFF) arrangement for SDR 413 million (USD4.31 million). The programs were put on hold after the first disbursements in 2003 due to lack of progress with key structural reforms. The current Government is not pursuing an IMF program as they do not intend to implement the kinds of economic reforms that would be required.

--ADB/WB Investment Climate Assessment

¶17. According to a joint Asian Development Bank (ADB)/World Bank (WB) investment climate assessment released in June 2005, Sri Lankan firms have identified sharply deteriorated infrastructure (electricity and transport) and cost of finance as major constraints for doing business. The study surveyed 450 urban and 1,300 rural firms during 2003/2004. Over 40 percent of urban firms cited electricity as the biggest constraint for investment followed by policy uncertainty, macro instability, cost of finance and labor regulations. Rural firms cited transport problems as the key constraint followed by cost and access to finance and marketing. Rural firms identified lack of electricity as the fifth biggest constraint. The survey also generally lists labor regulations and infrastructure deficiencies as the most severe constraints affecting FDI. Other perceived constraints to FDI were concerns about the peace process, and economic and regulatory policy uncertainty.

--Possible Post-Tsunami Commercial Opportunities

¶18. There may continue to be commercial opportunities for US companies in the post-tsunami reconstruction program. The bulk of reconstruction expenditure will be spent on housing, transportation infrastructure (roads, railway and ports), fisheries infrastructure (harbors, anchorage and related facilities), water supply and sanitation projects, and school and hospital buildings. There may also be opportunities in public infrastructure programs. The government plans to undertake several development programs in the next few years. The 2006 budget estimates a 51 percent increase in the public investment program.

--Risks to the Economy

¶19. Numerous risks and challenges to the economy remain. Continuing cease-fire talks might not lead to tangible progress on peace. Despite his recent electoral victory, President Rajapaksa must depend on an inherently unstable Parliamentary coalition. There are concerns regarding the speed of reconstruction and resettlement of the tsunami affected population. Other down-side risks will stem from uncertainties over oil prices, government fiscal largesse and the continued impact of the end of the Multi-Fiber Agreement, which set quotas on developing country textile exports to developed countries, although large factories accounting for the bulk of the exports are expected to continue to perform well. Another major business concern in the medium term is the cost and availability of power. Sri Lanka has faced episodic power shortages, with the most recent period extending from mid 2001 to early 2002. Although new power plants have been added, the government has yet to procure sufficient low-cost base load power to avert a power crisis in the medium term. There has been some recent activity toward a 300 megawatt coal plant from China, though the government is still to prove that it can deal with entrenched opposition in the community around the proposed site. Despite the dire need for power, the JVP resists Government moves to restructure the state owned electrical utility board, thus reducing the

possibility of solving power problems in the foreseeable future. High oil prices are also causing an already inefficient and money losing state-owned electrical company to face serious cash flow difficulties and to backtrack on power purchase agreements and contractual obligations. Uncertainty over the future of the energy sector has led most businesses to install onsite generating capacity.

--Board of Investment

¶20. The Board of Investment (BOI) (www.boi.lk), an autonomous statutory agency, is the primary government authority responsible for investment, with a particular emphasis on foreign investment. The BOI acts as a facilitator for investment. It is intended to provide "one-stop" service for foreign investors, with duties including approving projects, granting incentives, and arranging services such as water, power, waste treatment and telecommunications. But the BOI is best at assisting investors who want to establish operations within its industrial processing zones. It also assists people in obtaining resident visas for expatriate personnel and facilitates import and export clearances. The BOI has undertaken a major review of its activities in order to improve its services. The Bureau for Infrastructure Investment (BII) (www.bii.lk), a division of BOI, has responsibility for

coordinating all private infrastructure projects. Projects are usually structured on the basis of build, own, operate (BOO), build, operate, and transfer (BOT) or build, own, operate, and transfer (BOOT).

--Laws Affecting Investment

¶21. The principal law governing foreign investment is Law No. 4, created in 1978 (known as the BOI Act), as amended in 1980, 1983 and 1992, along with implementation regulations established under the Act. The BOI Act provides for two types of investment approvals. Under section 17 of the Act, the BOI is empowered to grant concessions (see details below) to companies satisfying certain eligibility criteria on minimum investment, exports and in some cases employment. Investment approval under section 16 of the act permits entry for foreign investment to operate under the "normal" laws of the country and applies to investments that do not satisfy eligibility criteria for BOI incentives. Other laws affecting foreign investment are the Securities and Exchange Commission Act of 1987 as amended in 1991 and 2003, and the Takeovers and Mergers Code of 1995 revised in 2003. Various labor laws and regulations affect investors also. See sections below.

--Foreign Equity and Sectors

¶22. The government relaxed investment rules in early 2002, allowing 100 percent foreign investment in the following services: banking, finance, insurance, stock-brokering, construction of residential buildings and roads, supply of water, mass transportation, telecommunications, energy production and distribution, professional services, and the establishment of liaison offices or local branches of foreign companies. These services are regulated and subject to approval by various government agencies. The screening mechanism is non-discriminatory and, for the most part, routine.

¶23. Investment in other sectors is restricted and subject to screening and approval on a case-by-case basis when foreign equity exceeds 49 percent. The affected sectors are: shipping and travel agencies; freight forwarding; fishing; timber-based industries;

growing and primary processing of tea, rubber, coconut, rice, cocoa, sugar and spices; and the production for export of goods subject to international quota. Foreign investment restrictions and government regulations also apply to international air transport; coastal shipping; lotteries; large-scale mechanized gem mining; and sensitive industries such as military hardware, dangerous drugs and currency.

¶24. Foreign investment is not permitted in the following businesses: non-bank money lending; pawn-brokering; retail trade with a capital investment of less than USD 1 million (with one notable exception: the BOI permits retail and wholesale trading by reputed international brand names and franchises with an initial investment of not less than USD 150,000); coastal fishing; and the awarding of local university degrees. Foreign degree courses can be offered in Sri Lanka by affiliating with foreign universities. However, there is no scheme to monitor the quality assurance or accreditation of the foreign courses offered in Sri Lanka.

¶25. Generally, the treatment given to foreign investors is non-discriminatory. In fact, some local companies have complained that they are discriminated

against, as qualifying foreign investors can benefit from a wide range of advantages. However, entry into sectors such as liquefied petroleum gas, flour milling and fixed line telephony are controlled, in order to ensure that currently existing monopolies or oligopolies supplying products or services in Sri Lanka are protected. Sri Lanka also does not have anti-competition laws. Even with incentives and BOI facilitation, foreign investors face difficulties operating here. Problems range from the mundane but critical matter of clearing equipment and supplies through customs speedily, to obtaining a factory site. Legal challenges to environmentally sensitive projects have been particularly challenging, even when objections are unfounded. Perhaps the most difficult barriers to investment are the enormous set of bureaucratic requirements and poor decision practices of GSL entities. Several high profile and needed infrastructural projects have dried up in the past two years, as investors simply tired of waiting for approval and action. In part to avoid part of these tangles, in addition to overcoming land allocation problems, the BOI encourages investors to locate their factories in industrial processing zones managed by the BOI. Investors locating in industrial zones also get access to relatively better infrastructure facilities such as reliable power, telecommunication and water supplies.

--Privatization Frozen

¶26. Previous governments, including ones headed by the SLFP, actively pursued privatization. When the UPFA Government came to power in 2004, however, it pledged to halt the privatization process of strategic enterprises and to institute more effective government oversight while privatizing smaller entities. The current Government has said that it will not privatize any government entity.

¶27. Government treatment of foreign investors in past privatization processes had been largely non-discriminatory. In 2003, however, the then UNP government sold part of the retail operations of state-owned Ceylon Petroleum Corporation (CPC) to Indian Oil Corporation (IOC) without a formal tender process. One US firm, which had earlier acquired a government-owned lubricant plant and obtained exclusivity in the sale of

lubricants in CPC outlets until mid-2004, has also complained that the government had reneged on the terms of the exclusivity agreement.

--Labor Unions Block Privatization

¶28. Labor unions in state-owned enterprises are often opposed to privatization and restructuring and seem particularly averse to foreign ownership. In the past, this made the purchase of certain strategic entities problematic for new foreign owners.

--Investment Trends

¶29. From 1998-2001, foreign direct investment (FDI) flows to Sri Lanka averaged only about USD 150 million per year (excluding privatization receipts). Following the commencement of the peace process and improved investor confidence, annual FDI flows have averaged about USD 200 million. Although initially FDI was expected to rise faster following the cease-fire, it has stagnated due to the stalemate in the peace process. In 2004, FDI was about USD 178 million. The Sri Lankan government reported with its budget an

anticipated USD 250 million of FDI for 2005, but this amount appears to be overstated since FDI had been about USD 110 million by October 2005. FDI could eventually be reported at less than USD 150 million for ¶2005. No single big investment occurred in 2005. Most 2005 FDI occurred in housing projects, existing business expansion, and spillover effects of investments that came in 2004 when FDI mainly funded telecommunications and manufacturing industries (cement and textiles).

--The Colombo Stock Exchange

¶30. The Colombo Stock Exchange (CSE) has been growing markedly since 2002, due to local investor activity. The CSE is taking steps to broaden the investor base both in Sri Lanka and abroad. The CSE has been one of the best performing stock markets globally since 2001 and has recorded a consistent annual growth of over 30 percent in market indices for the last 4 years. However, the November 2005 election of President Mahinda Rajapaksa backed by Marxist JVP and a string of serious cease-fire violations dampened the market in December 2005. Foreign investors have largely stayed out of the market, and were net sellers in 2003-2004. Uncertainty about the peace process, weak macro economic fundamentals, and reversals in economic reforms, are major concerns to foreign investors.

CONVERSION AND TRANSFER POLICIES

¶31. Sri Lanka has accepted Article VIII status of the IMF and has liberalized exchange controls on current account transactions. There are no surrender requirements on export receipts, but exporters need to repatriate export proceeds within 120 days to settle export credit facilities. Other export proceeds can be retained abroad. Currently, contracts for forward bookings of foreign exchange are permitted for a maximum period of 360 days for the purposes of payments in trade and 720 days for the repayment of loans.

¶32. There are also no barriers, legal or otherwise, to the expeditious remitting of corporate profits and dividends for foreign enterprises doing business in Sri Lanka. Remittance of business fees (management fees, royalties and licensing fees) is also freely permitted for companies with majority foreign investment approved

under Section 17 of the BOI Act. Other companies require Central Bank approval. Funds for debt service and capital gains of BOI-approved companies exempted from exchange control regulations are freely permitted. Other foreign companies remitting funds for debt service and capital gains require Central Bank approval. All stock market investments can be remitted without prior approval of the Central Bank through a special bank account. Investment returns can be remitted in any convertible currency at the legal market rate. Controls on capital account (investment) transactions usually prohibit foreigners from investing in debt and fixed income securities. One exception has been the Central Bank?s dollar denominated bond issues in the local market that were opened to foreign investors. It has been proposed to allow foreigners to invest in corporate debentures and government bonds.

¶33. Local companies require Central Bank approval to invest abroad. The process of granting approval for such investments was streamlined in 2002, resulting in a substantial increase in approvals.

EXPROPRIATION AND COMPENSATION

¶34. Since economic liberalization policies began in 1978, the Sri Lankan Government has not expropriated a foreign investment. Under the terms of the US/Sri Lanka Bilateral Investment Treaty (BIT), investors have the right to arbitration under the International Center for the Settlement of Investment Disputes (ICSID) of the World Bank. The last expropriation dispute was resolved in 1998.

DISPUTE SETTLEMENT

--Legal System

¶35. Sri Lanka's legal system reflects diverse cultural influences. Criminal law is fundamentally British. Basic civil law is Roman-Dutch. Laws pertaining to marriage, divorce, and inheritance are communal. Sri Lankan commercial law is almost entirely statutory. The law was codified before independence in 1948 and reflects the letter and spirit of British law of that era. Its amendments have, by and large, kept pace with subsequent legal changes in the U.K. Until recently, the court system was largely free from government interference. There are allegations that the judiciary is sometimes subject to political influence, but this has not been evident in commercial litigation so far. Procedures exist for enforcing foreign judgments. Litigation can be very time consuming. Several important legislative enactments regulate commercial matters: the Board of Investment Law, the Intellectual Property Act, the Companies Act, the Securities and Exchange Commission Act, the Banking Act, the Industrial Promotion Act and Consumer Affairs Authority Act. Most of these laws were revised recently.

--Bankruptcy Laws

¶36. The Companies Act and the Insolvency Ordinance provide for dissolution of insolvent companies. But currently, there is no mechanism to facilitate the re-organization of financially-troubled companies. Other laws make it very difficult to keep a troubled company afloat. The Termination of Employment of Workmen Act (TEA), for example, prohibits employers from dismissing workers even on the grounds of inefficiency. The

Termination Act was recently revised to facilitate retrenchment. Under the revised act, a compensation formula for retrenched workers has been published. But employers have protested that it is excessive compared to similar formulae in the Asian region, with terms in Sri Lanka about twice as generous as the East Asian average. [Please see section on ?LABOR? for details]. Obviously, this compensation plan could adversely affect companies? restructuring plans and discourage future employment growth.

¶37. In the absence of proper bankruptcy laws, extra-judicial powers granted by law to financial institutions protect the rights of creditors and have helped strengthen credit discipline. Lenders are able to enforce financial contracts through powers that allow them to foreclose on loan collateral without the intervention of courts. A recent judgment, however, ruled that these powers would not apply with respect to collateral provided by guarantors to a loan. Financial

institutions also face other legal challenges as defaulters obtain restraining orders on frivolous grounds due to technical defects in the recovery laws. Also, for default cases filed in courts, the judicial process is time consuming. The private sector has urged the government to introduce US Chapter 11-style bankruptcy laws, although the enactment of a similar procedure is unlikely as government officials currently take a dim view of this approach. Additionally, the financial community has requested the strengthening of debt recovery laws.

--Investment Protection

¶38. In principle, foreign investments are guaranteed protection by the Constitution of Sri Lanka. The government has entered into 24 investment protection agreements with foreign governments (including the United States) and is a founding member of the Multilateral Investment Guarantee Agency (MIGA) of the World Bank. Sri Lanka is also a founding member of the World Trade Organization. The government has ratified the Convention on Settlement of Investment Disputes, which provides the mechanism and facilities for international arbitration through the World Bank?s ICSID.

¶39. The U.S.-Sri Lanka Bilateral Investment Treaty (BIT) was ratified by both governments in early 1993. A bilateral treaty to prevent double taxation went into effect on June 12, 2004.

¶40. Settlement of disputes through the Sri Lankan court system is subject to protracted and inexplicable delay. Aggrieved investors (especially those dealing with the government of Sri Lanka on projects) have frequently pursued out-of-court settlements, which offer a possibility of speedier dispute resolution.

--Arbitration

¶41. The Arbitration Act of 1995 gives recognition to the New York Convention on recognition and enforcement of foreign arbitral awards. Arbitral awards made abroad are now enforceable in Sri Lanka. Similarly, awards made in Sri Lanka are enforceable abroad. A center for arbitration known as the Institute for the Development of Commercial Law and Practice (ICLP) has been established in Colombo for the expeditious, economical, and private settlement of commercial disputes. The ICLP appears unlikely to become involved in disputes involving the Sri Lankan Government, the source of most disputes with U.S. companies in recent years.

¶42. Sri Lanka's first commercial mediation center was established in 2000 and became operational in mid 2001. Commercial mediation is conducted under the Commercial Mediation Act. Interest in mediation is still low.

¶43. The Labor Department has a process involving labor tribunals for settling industrial disputes with laborers or unions, and arbitration is required when attempts to reconcile industrial disputes fail. The Labor Commissioner typically becomes involved in labor-management mediation. Other senior officials, including the Labor Minister, and the President, have intervened in particularly difficult cases.

--Investment Disputes Involving U.S. Companies

¶44. There continue to be trade and investment

disputes, particularly surrounding government procurement. The government procurement process in Sri Lanka is slow and opaque. US companies continue to face problems with payment of valid contracts, finalization of agreement language, implementation of agreements with the Government, and inexplicable failure to secure contracts, despite demonstrated superior performance, high value, and low bids. Some US companies have found it difficult to secure payment for power generation due to CEB?s tight cash flow situation, with at least one major payment currently disputed by the Government under the ironic theory that the Government was forced to enter into a contract ?under duress? because a fire forced an energy plant to produce energy in a more costly manner than prior to the fire. The Government had asked the plant?s management to continue operations, and the company despite management?s strong preference to shut down for repairs.

¶45. In May 2000, the Sri Lankan Supreme Court effectively blocked an existing investment agreement between the Government of Sri Lanka and a US mining company. Although the investment agreement was already initialed and approved by the Sri Lankan cabinet, work on the project had not yet begun. A group of citizens filed a fundamental rights case under a Sri Lankan law that allows any person to seek protection from the Supreme Court if a government or administrative act impedes his/her rights. In this case, the plaintiffs alleged that their rights would be violated if the project was implemented, and the court upheld their complaint. Without any technical argument, a partial bench of three judges ruled that the project could not proceed before completion of a new series of detailed and highly comprehensive and expensive studies, some of which appeared to be technically impractical. Because this is a Supreme Court decision, options for reversing the decision appear limited.

¶46. In another case, a US investor with a substantial investment in an export manufacturing company has faced lengthy delays in a court case over a large insurance claim. The company instituted legal action in June 1999 and court proceedings are still ongoing. The Company withdrew its operations from Sri Lanka in 2004. In many disputes, defendants resort to obtaining injunctions, stay orders, or postponements to drag cases on for years.

PERFORMANCE REQUIREMENTS/INCENTIVES

--Performance Requirements

¶47. The Board of Investment specifies certain minimum investment amounts for both local and foreign investors to qualify for incentives. Firms enjoying preferential incentives in the manufacturing sector in most cases are required to export 80 percent of production, while those in the service sector must export at least 70 percent of production. Sri Lanka complies with WTO Trade Related Investment Measures (TRIMS) Obligations.

¶48. Foreign investment is encouraged in information technology, electronic assembly, light engineering, automobile parts and accessories manufacturing, industrial and IT parks, rubber based industries, information and communication services, tourism and leisure related activities, agriculture and agro processing, port-related services, regional operating

headquarters, and infrastructure projects. Foreign investors are generally not expected to reduce their equity over time, nor are they expected to transfer technology within a specified period of time, except for build-own-transfer or other such projects in which the terms are specified within pertinent contracts.

¶49. In some BOI-approved enterprises, businesses are required to maintain certain levels of employment. In addition, privatization agreements prohibit new owners from dismissing workers as a rule, although the owners are free to offer voluntary retirement packages to reduce their workforce. Some foreign investors have received political pressure to hire workers from a particular constituency or a given list, but have successfully resisted such pressure with no apparent adverse effects.

¶50. Foreign investors who remit at least USD 50,000 can qualify for a one-year resident visa, which can be renewed. Employment of foreign personnel is permitted when there is a demonstrated shortage of qualified local labor. Technical and managerial personnel are in short supply, and this shortage is likely to continue in the near future. Foreign employees attached to BOI-approved companies usually receive preferential tax treatment for an initial period and do not experience significant problems in obtaining work or residence permits.

--Investment Incentives

¶51. The Board of Investment has announced the following investment incentives, with such investments typically requiring prior approval of various ministries:

Incentive Program I

Qualifying industries:
--Non-traditional manufacturing exports and companies supplying to exporting companies. Minimum investment of USD 150,000;
--Export oriented services. Minimum investment of USD 150,000;
--Manufacture of industrial tools and/or machinery. Minimum investment of USD 150,000;
--Small-scale infrastructure. Minimum investment of USD 500,000;
--Research and development. Minimum investment of USD 50,000;
--Agriculture and agro processing industries. Minimum investment of USD 10,000;

Incentives: Above industries will qualify for a five-year tax holiday initially. A preferential tax of 10 percent in the 6th and 7th years follows the tax holiday. After the 7th year, a preferential tax of 15-

20 percent will apply. In addition, these industries qualify for duty-free imports (generally, during the life of the project for export-oriented projects, and during the project implementation period for others). Exporting companies and export-oriented services will be exempted from exchange control regulations. They will also qualify for free repatriation of profits and dividends and free transferability of shares. A recently introduced Economic Service Charge at 0.25 percent of income will be applicable to BOI approved companies with tax holidays, from the fourth year of operation. The tax applies even to existing companies. There is no grandfather clause.

Incentive Program II

Qualifying Industries:
--Information technology services such as call centers, data entry services, data centers, software development services, host centers for e-governance and related projects;
--IT training institutes;
--Regional operating headquarters providing the following services to related businesses outside Sri Lanka: sourcing raw materials, R&D, technical support, financial and treasury management, marketing and sales promotion;
--Any industrial, agricultural, service, or construction activity approved by the BOI. Minimum investment of USD 5 million.

(a) Minimum employment of 15 IT professionals is required in IT companies
(b) Minimum 300 students required for IT training institutes.

Incentives: Above industries will qualify for a 3-year tax holiday period initially. A preferential tax of 10 percent will apply in the 4th and 5th years. From the 6th year onwards, a preferential tax of 15-20 percent will apply. In addition, capital goods will be exempted from import duty. A recently introduced Economic Service Charge at 0.25 percent of income will be applicable to BOI approved companies enjoying tax holidays, from the fourth year of operation. The new tax applies even to those companies already operating in Sri Lanka.

--Incentives for Regional Development

¶52. The BOI has launched a new incentive program to promote regional development with the aim of establishing 300 new factories or service companies (such as hotels, hospitals, training institutes) in the regions outside the capital Colombo. The incentives include 5-10 year tax holidays depending on the location, with firms going to most difficult areas eligible for a 10-year tax holiday. In addition, imports of machinery and equipment would be exempted from both customs duty and the value-added tax.

--Infrastructure development

¶53. Companies acquiring existing companies in petroleum, power generation, transmission, development of highways, sea ports, airports, railway, water services, public transport, agriculture and agro processing and other infrastructure projects approved by the BOI will qualify for tax holidays ranging from 5 to 10 years depending on the magnitude of investment. A preferential tax of 15 percent will follow after the tax holiday period. These companies will also qualify for duty free imports of capital goods. A minimum investment of USD 12.5 million is required.

¶54. Large-scale new infrastructure projects in power generation, transmission and distribution; development of highways, seaports, airports, public transport and water services; establishment of industrial parks, and other infrastructure projects approved by the BOI will qualify for tax holidays ranging from 6 to 12 years depending on the size of the investment. A preferential tax of 15 percent will follow the tax holiday. They will also qualify for duty free imports of capital goods. A minimum investment of USD 10 million is required.

--Trade Agreements to Make Sri Lanka a Gateway to South Asia; ?GSP-Plus?.

¶55. A preferential trade agreement, the Indo Lanka Free Trade Agreement (ILFTA) between Sri Lanka and India, is now in operation. Under this agreement, most products manufactured in Sri Lanka with at least 35 percent domestic value addition (if raw materials are imported from India, domestic value addition required is only 25 percent), qualify for duty free entry to the Indian market. Tariff concessions for Sri Lankan products include zero tariffs on 4,150 items; 50 to 75 percent reduction for tea and garments under quota; 25 percent reduction for 528 items, and no reduction for 429 items (negative list). Discussions are underway to reduce the negative lists of both countries. The two countries are discussing services sector liberalization, under a proposed Comprehensive Economic Partnership Agreement (CEPA). Other areas covered by the CEPA are investment and economic cooperation. Because production constitutes a portion of the value, ILFTA and the proposed CEPA may be well utilized as a mode of entry into the Indian market by U.S. companies.

¶56. Sri Lanka also signed a free trade agreement with Pakistan that came into operation on June 12, 2005. Under the Sri Lanka-Pakistan FTA (SLPKFTA) (www.doc.gov.lk), Pakistan has offered duty free entry to 206 items. Pakistan?s negative list contains 541 items with no duty concessions. Pakistan will phase out tariffs on the balance of approximately 4,000 items over a 3 year period. Under the agreement, Pakistan would offer duty free entry to all Sri Lankan exports by June 2008.

¶57. Sri Lanka and six other south Asian nations belonging to the South Asia Association for Regional Cooperation (SAARC) signed a South Asia Free Trade Agreement (SAFTA) in January 2004. SAFTA was launched on January 1, 2006 and will become operational on July 1, 2006. SAFTA will offer regionalized tariff reductions for imports from member countries. Stated goals of SAARC members under SAFTA are to reduce duties for imports from member countries to between zero and 5 percent over a period of 7-10 years. These agreements are seen as steps towards making Sri Lanka a regional hub and a gateway to South Asia and the Middle East for foreign investors

¶58. Sri Lankan exports to EU are also duty free under the ?GSP-Plus? incentive scheme which came into force on July 1, 2005. Under this program, 7,200 Sri Lankan products meeting rules-of-origin criteria can enter the EU duty free.

--Prospects for U.S. Investment under Indo Lanka Free Trade Agreement (ILFTA) and Pakistan Sri Lanka Free Trade Agreement (SLPKFTA).

¶59. Foreign investors in Sri Lanka can enjoy preferential access to the Indian and Pakistan markets under the ILFTA and SLPKFTA. The BOI hopes to attract foreign joint ventures to Sri Lanka under these

agreements. The BOI has picked several product sectors for promotion under the agreements, and targets its investment promotion efforts to countries and companies manufacturing them. The selected products, if manufactured in Sri Lanka and meet rules of origin criteria, are eligible for duty free entry into India. The products targeted for Pakistan will qualify for a 34 percent duty reduction immediately and will see duties coming down to zero over three years. The BOI has identified the following sectors for investment

promotion under the ILFTA and SLPKFTA:

--ILFTA: confectionary and cocoa products, rubber products, plastic, footwear, ceramic, jewelry, machinery and mechanical appliances, electronics and electrical products, automobiles and spares parts, medical instruments and furniture and doors.

--SLPKFTA: rubber products, ceramic, machinery and mechanical appliances, electronics and electrical appliances, medical instruments and automobiles and spare parts.

¶60. Some US companies currently avail themselves of the ILFTA by adding at least 35 percent value in Sri Lanka and getting import duties into India reduced from as much as 40 percent to as little as zero.

¶61. For further information on investment incentives and other investment-related issues, potential investors are encouraged to contact the Board of Investment directly. The BOI can be found at www.boi.lk, or reached via e-mail at info@boi.lk. The BOI is planning to create an investor matchmaking service via the BOI website. Information regarding this service could be found on www.boi.lk/partnership.

RIGHT TO PRIVATE OWNERSHIP AND ESTABLISHMENT

¶62. Private entities are free to establish, acquire, and dispose of interests in business enterprises. Private enterprises enjoy benefits similar to those granted to public enterprises, and there are no known limitations to access to markets, credit, or licenses. Foreign ownership is allowed in most sectors. Private land ownership is limited to fifty acres per person. The government owns about 80 percent of the land in Sri Lanka, including the land housing most tea, rubber, and coconut plantations. The government has leased most of these plantations to the private sector on 50-year terms. Although state land for industrial use is usually allotted on a 50-year lease, 99-year leases may also be approved on a case-by-case basis, depending on the nature of the project.

¶63. While foreign investors can purchase land from private sellers, the government recently imposed a 100 percent tax on land transfers to foreigners. It also imposed a definition of foreign investment to include corporations with as little as 25 percent foreign ownership ? a definition that can be particularly difficult for companies listed on the Colombo Stock Exchange since on any particular day, their ownership characteristics may vary. Apartments above the third floor of condominium buildings, land for the development of large housing schemes, hospitals and hotels with a minimum investment of USD 10 million, exporting companies with a minimum investment of USD 1 million, and large infrastructure projects with a minimum investment of USD 50 million are to be exempted from the tax. Foreigners maintaining USD 150,000 in a bank account in Sri Lanka will be given concessionary treatment. Regulations regarding these exceptions have

been published in Gazette No 1386/18 dated March 30,
¶2005.

PROTECTION OF PROPERTY RIGHTS

--Property rights: problematic but may be improving

¶64. Secured interests in property are recognized and enforced. A fairly reliable registration system exists for recording private property including land, buildings and mortgages. However, there have been problems due to fraud and forged documents. The Government has begun to address these issues under a World Bank-sponsored judicial reforms project. The legal system is nondiscriminatory and protects and facilitates acquisition and disposition of property rights by foreigners, although it has recently become subject to political influence.

¶65. Private farmers generally work state-owned lands under varying tenure agreements, ranging from restrictive tenures to land grants, although the property rights to these lands are frequently ill-defined. Changes to the legal framework covering land titling have been proposed under a World Bank-funded project. These changes aim to establish land tenure, remove restrictions related to the sale, leasing and transfer and mortgaging of rural lands previously distributed to farmers by the Government. The project has also implemented a model computerized land titling system in a few villages. The Government has sought World Bank assistance to extend the system to cover the entire country. Such a project, yet to be designed and approved, would take about 6 years to implement.

--Intellectual Property Rights Protection

¶66. Sri Lanka is a party to major Intellectual Property Agreements including the Berne Convention for the Protection of Literary and Artistic Works, the Paris Convention for the Protection of Industrial Property, the Madrid Agreement for the Repression of False or Deceptive Indication of Source on Goods, the Nairobi Treaty, the Patent Co-operation Treaty, the Universal Copyright Convention, and the Convention establishing the World Intellectual Property Organization (WIPO).

¶67. Sri Lanka and the US signed a Bilateral Agreement for the Protection of Intellectual Property Rights in 1991, and Sri Lanka is also a party to the Trade Related Intellectual Property Rights (TRIPS) Agreement in the World Trade Organization. Enforcement of these agreements, however, is in its infancy.

¶68. A new intellectual property law came into force in November 2003. It meets both US-Sri Lanka bilateral IPR agreement and TRIPS obligations to a great extent. The IPR law governs copyrights and related rights, reproduction rights, public distribution rights, industrial designs, patents for inventions, trademarks and service marks, trade names, layout designs of integrated circuits, geographical indications, unfair competition, databases, computer programs, and undisclosed information. The law also covers the rights of performers, producers of sound recordings, and broadcasting organizations. All trademarks, designs, industrial designs and patents must be registered with the Director General of Intellectual Property.

¶69. Infringement of Intellectual Property Rights (IPR)

is a punishable offense under the law. Intellectual Property Rights come under both criminal and civil jurisdiction. Relief available to owners under the new law includes injunctive relief, seizure and destruction of infringing goods and plates or implements used for the making of infringing copies, and prohibition of

imports and exports. Police can take ex-officio action to enforce the law. Aggrieved parties can also, on their own, seek redress for any IPR violations through the courts, though this can be a frustrating and time-consuming process.

¶70. Although the legal system is well-established and non-discriminatory, it is fraught with long delays. IPR enforcement was a serious problem under the old law, and public awareness of IPR continues to be limited. Under the old law, domestic implementation legislation was very weak and the government did not act as an enforcer of IPR laws.

¶71. With the passage of the new law, Sri Lanka has begun to enforce IPR laws. However, it will take time before new procedures and court precedents are established. In October 2004, Sri Lankan Police raided an illegal CD manufacturing plant owned by Malaysian nationals. In December 2005, the courts fined a Malaysian employee of the company (the only person arrested for the crime), Rs 40,000 (USD 400) for illegal possession of CDs and DVDs and handed down a suspended prison sentence of 24 months. The Police carried out additional raids of counterfeit CD/VCD stores as well as counterfeit garment sellers in 2005. Customs has also seized counterfeit consumer goods, mainly cigarettes. Vendors of pirated CDs, DVDs and garments were fined and received suspended jail sentences in Sri Lanka?s courts, suggesting minor progress in the enforcement of the new law. Meanwhile, local agents of reputed US and other international recording companies, software development companies, motion picture companies, clothing companies and consumer product companies continue to complain that lack of IPR protection is damaging their businesses. Further, CD/VCD stores that were raided in early 2005 again sell pirated goods and a ?trade association? to look after the interest of pirates and distributors was established. The association claims that IPR enforcement violates its members? right to generate business. The Embassy, along with key industry players including the IFPI, continues to lobby the government to improve Sri Lanka's IPR regime.

¶72. Sri Lanka needs to ratify and conform to the WIPO Performances and Phonograms Treaty (WPPT) and the WIPO Copyright Treaty (WCT). Ratification of these two treaties will support electronic commerce, protect the rights of performers and producers of phonograms and the rights of authors in their literary and artistic works, and offer an adequate basis to fight international piracy in view of new technological developments. Sri Lanka lacks provisions to deal with electronic transactions, electronic signatures, and computer crimes and evidence, although draft laws to deal with these matters have been finalized. The IPR law does not cover protection of new plant varieties.

--Patents, Copyrights and Trademarks

¶73. Patents are granted for inventions, with the following exceptions: discoveries, scientific theories and mathematical methods, plant or animal varieties (other than micro biological processes) and essentially biological processes for the production of plants and animals (other than non biological and microbiological processes), business rules and methods, methods of

treatment by surgery or therapy, and diagnostic methods practiced on a human or animal body. The law also permits compulsory licensing and parallel imports of pharmaceutical products. Compulsory licensing will

allow the government to grant licenses to manufacture certain patented drugs, overruling patent licenses in a national emergency. The parallel imports will allow the import of a branded drug from an alternative source.

¶74. A patent is valid for 20 years from the date of application but must be renewed annually.

¶75. Copyrights are not registered. A work is protected automatically by operation of law. Original literary, artistic, and scientific works including computer programs and databases are protected under the new law. There are enforcement limitations applying to copyrights, including software.

¶76. Sri Lanka recognizes both trademarks and service marks. The exclusive right to a mark is acquired by registration. A mark may consist of words, slogans, designs, etc. Protection also is available to well known marks not registered in Sri Lanka. For instance, the Supreme Court of Sri Lanka recently held that a local company did not have a right to use the MTV trademark owned by Viacom International of the U.S. Registered trademarks are valid for ten years and renewable. The law also recognizes both certification marks and collective marks.

TRANSPARENCY IN THE REGULATORY SYSTEM

¶77. The BOI strives to inform potential investors about laws and regulations that may affect operations in Sri Lanka. Laws pertaining to tax, labor and labor standards, exchange controls, customs, environmental norms, and building and construction standards are in place. However, some of the laws and regulations are not freely available and are difficult to access. Foreign and domestic investors often complain that the regulatory system allows far too much leeway for bureaucratic discretion. Outdated regulations and rigid administrative procedures imposed by public sector institutions have been identified as impediments to private sector growth. Effective enforcement mechanisms are sometimes lacking, and coordination problems between the BOI and relevant line agencies frequently emerge. Lethargy and indifference on the part of mid- and lower-level public servants compound transparency problems. Lack of sufficient technical capacity within the government to review financial proposals for private infrastructure projects also creates problems during tendering. In late 2005, the Government awarded several key infrastructure projects to Chinese companies, outside the tender process. They include a 300 megawatt coal power project and a bunkering project.

¶78. Although many foreign investors, including US firms, have had positive experiences in Sri Lanka, some have encountered significant problems with government practices and regulations. Some multinational firms have experienced extensive unexplained delays in trying to reach agreement on investment projects. Others have had contracts inexplicably canceled without compensation, even though the Sri Lankan Cabinet had approved those contracts.

EFFICIENT CAPITAL MARKETS AND PORTFOLIO INVESTMENT

--Availability of financial resources

¶79. Retained profits finance about 70 percent of private investment, with short term borrowing financing a further 20 percent of investment. The stock market and corporate securities market have not been significantly used to raise capital. FDI finances about 4 percent of investment.

¶80. The State consumes over 50 percent of the country's domestic financial resources and has a virtual monopoly on the management and use of long-term savings in the country. This inhibits the free flow of financial resources to product and factor markets. In the past, high interest rate volatility, due to excessive use of short term borrowing by the state, increased intermediate costs, which led to higher costs to other borrowers. Since 2002, government policy has supported a low interest rate regime and has given impetus to increased credit, which has contributed to increased domestic investment as well as inflation. The investment/GDP ratio rose to 26 percent in 2005, compared with 22 percent in 2001. The prime lending rate currently averages 12 percent. Foreign investors are allowed to access credit on the local market. They are also free to raise foreign currency loans.

¶81. A total of Rs 12.3 billion (approx. USD 123 million) was raised in the primary market by way of new equity and debt in 2004, reflecting the potential for companies to raise funds through the market.

--Credit Instruments

¶82. Commercial banks and two development finance institutions, the National Development Bank (NDB) and the Development Finance Corporation of Ceylon Bank (DFCC), are the principal source of bank finance. Bank loans are the most widely used credit instrument for the private sector. Financial institutions such as the DFCC Bank and some commercial banks also raise syndicated bank loans to fund large-scale investment projects undertaken by the private sector.

¶83. The domestic debt market in Sri Lanka is still at a very nascent stage. The first credit rating agency, Fitch IBRC (www.fitchratings.lk) opened an office in Colombo in 1999, which has helped companies to raise funds through debt markets. Fitch Ratings Lanka Ltd, is a joint venture between Fitch IBRC, IFC, the Central Bank of Sri Lanka, and several local financial institutions. Credit ratings are now mandatory for all deposit-taking institutions and for all varieties of debt instruments.

--Accounting Standards

¶84. There is an active and fairly competent accounting profession, based on the British model. The source of accounting standards is the Institute of Chartered Accountants of Sri Lanka (ICASL), and standards are constantly updated to reflect current international accounting and audit standards. Sri Lanka carried out a major revision of accounting and auditing standards in September 1997. Since then, the standards have been periodically updated to meet new international standards adopted by the International Accounting Standards Board (IASB). Due to the lack of an adequate enforcement mechanism, however, problems with the quality and reliability of financial statements still exist.

¶85. Sri Lanka accounting standards are applicable for all banks and stock exchange listed companies and all other large- and medium-sized companies in Sri Lanka. Accounts of such business enterprises are required to be audited by professionally qualified auditors holding ICASL membership. ICASL has recently published accounting standards for small companies as well. The Accounting Standards and Monitoring Board (ASMB) is responsible for monitoring compliance with Sri Lankan accounting and auditing standards. There is an active presence of British professional accounting bodies in Sri Lanka. The Chartered Institute of Management Accountants (CIMA), a leading professional accounting body based in the UK and spread over the Commonwealth has its largest overseas presence in Sri Lanka.

--Securities and Exchange Commission

¶86. The Securities and Exchange Commission (SEC) regulates the securities market in Sri Lanka. The SEC law was revised in 2003, enhancing its coverage and investigative powers. The SEC now covers stock exchanges, unit trusts, stock brokers, listed public companies, margin traders, underwriters, investment managers, credit rating agencies and securities depositories.

¶87. Foreign investors can freely purchase up to 100 percent of equity in Sri Lankan companies in numerous permitted sectors. In order to facilitate portfolio investments, country funds and regional funds are also allowed to invest in Sri Lanka's stock market. Such funds must first receive Ministry of Finance approval to operate in Sri Lanka. These funds make transactions through share investment external rupee accounts maintained in commercial banks.

¶88. Sri Lanka?s SEC was rocked by a scandal in early 2003, tarnishing the image of the market watchdog. The SEC Chairman and another leading businessman were implicated for insider dealing at a blue chip local conglomerate where they were both directors. Initial attempts by the SEC secretariat to institute legal actions against the two were blocked by the SEC Board of Directors. Later, the Attorney General ruled that the SEC Board had acted improperly, casting doubt on the board members? credibility. The SEC Chairman resigned and later pleaded innocence. The two parties subsequently came to an out-of-court settlement.

¶89. The SEC scandal has caused many to call for increased corporate governance and accountability in the private sector. Some business consultants have asked for laws such as the US Sarbanes-Oxley Act to regulate financial services and professional services organizations.

--Colombo Stock Exchange

¶90. The Colombo Stock Exchange (CSE), while small by "big emerging market" standards, is one of the most technologically sophisticated in the region. The CSE has fully automated trading, clearing and settlement systems. The CSE has a rolling settlement period of five days for buyers and six days for sellers. Fifteen local and foreign joint venture brokers currently operate at the CSE. Foreign stockbrokers are permitted to hold up to 100 percent equity in stock brokerage firms operating at the CSE. SEC has a settlement guarantee fund with an initial capital of Rs 100 million (USD 1 million) which aims to guarantee the settlement of trades between clearing members of the

exchange. The Chartered Financial Analysts (CFA) program is conducted in Sri Lanka.

¶91. Acquisition of companies through mergers and takeovers is governed by the Takeovers and Mergers Code of 1995 made under the Securities and Exchange Commission of Sri Lanka Act. This law applies only to companies listed on the Colombo Stock Exchange. It is modeled on the lines of the London City Code on Takeovers and Mergers. Acquisition of more than a 30 percent stake of a listed company requires the buyer to make an offer to all other shareholders. The articles of association of a few listed companies restrict foreign equity to certain levels.

¶92. There are 242 companies listed on the stock exchange with the top ten positions by market capitalization held by banks and food and beverage companies. In 2003-2005, CSE was one of the best performing markets in the world. The Cease-Fire Agreement between the Government of Sri Lanka and the LTTE has helped to boost investor confidence. Following the November 17, 2005 election of President Mahinda Rajapaksa, the CSE has fluctuated in part depending on the level of violence in the northern and eastern provinces and hopes for improvement due to the cease-fire talks. During 1998-2001, the Colombo Stock Market experienced a sharp downturn due to a variety of local and international factors. As a result, the CSE was removed from the Morgan Stanley Capital International (MSCI) Index in 2001. It has not been reclassified in the MSCI yet, despite recent surge driven mainly by locals. Meanwhile, the California Public Employees? Retirement System (CalPERS), a large public pension fund for the state of California, which designated Sri Lanka a permissible country for investments in 2005, lowered its overall score for Sri Lanka in its latest review in 2006 to 1.8 from 2.00 in ¶2005. The threshold for inclusion in CalPERS is 2.00 and Sri Lanka?s position is to be reviewed after one year. The index is based on political stability, transparency, labor productivity, market liquidity, capital market openness, investor protection, and transaction cost.

¶93. The single overriding factor inhibiting the sustainable development of the stock market has been the conflict in the North and East and its effect on investor confidence and the economy as a whole. Other broader issues include lack of liquidity and limited market size. Improvements are also needed in corporate governance, accountability, and public disclosure in companies. The Accounting and Auditing Standards Monitoring Board, the Ceylon Chamber of Commerce, the Colombo Stock Exchange, and professional accounting bodies are taking initiatives in these areas.

--Banking System

¶94. Sri Lanka has a fairly well diversified banking system. There are 23 commercial banks, consisting of eleven local banks and twelve foreign banks. In addition, there are thirteen local specialized banks. Citibank NA is the only US bank operating in Sri Lanka and has expanded its operations recently. ICIC Bank of India is the newest foreign bank in Sri Lanka and commenced operations in January 2006. In 2001-2003, Mashreq Bank, American Express Bank, Nova Scotia Bank and ABN Amro Bank all sold their banking operations in Colombo to existing banks. Sri Lanka experienced its first bank failure in December 2002 when the Central Bank took action to revoke the license of a small

licensed specialized bank as its financial condition deteriorated to insolvency. There has not been any fallout for other banks from this incident. Two other small troubled banks were restructured under Central Bank guidance. In April 2005, the Central Bank introduced higher capital requirements for commercial banks in an effort to enhance the banking system stability, promote consolidation and facilitate entry of larger banks.

¶95. The Central Bank is responsible for supervision of all banking institutions. Wide-ranging improvements have been made in banking regulations and in public disclosure of banking sector performance. In 2002 the Monetary Law Act (MLA) was amended to provide the Central Bank broader supervisory powers and greater independence. The Bank also issued a code of corporate governance for banks and financial institutions in ¶2002. In addition, rules on classification and provisioning were improved significantly from January ¶2004. Further, the Banking Act was amended in 2005 to give additional supervisory powers to the Central Bank and to introduce guidelines to check the suitability of bank directors. The amended Banking Act outlaws pyramid-type programs. Further amendments to the laws are also expected in the next two years under ongoing financial and legal reforms programs. The Central Bank however still suffers from lack of autonomy, especially with regard to the large state owned banks.

¶96. In 2004, the Central Bank introduced technical improvements to facilitate banking sector efficiency by establishing a Real Time Gross Settlement (RTGS) system and a Scriptless Securities Settlement (SSS) system. They have improved the efficiency and the safety of the country?s payment and settlement systems and will facilitate trade in government securities.

¶97. Central Bank supervision as well as auditing practices of private audit firms came under criticism after the 2002 specialized bank failure mentioned above. The Central Bank obtained the services of an international expert to strengthen bank supervision in ¶2004.

--State Owned Banks

¶98. Total assets of commercial banks stood at Rs 1,028 billion (USD 10 billion) as of December 31, 2004. The two state-owned commercial banks, Bank of Ceylon and People?s Bank with assets of Rs 266 billion (USD 2.7 billion) and Rs 224 billion (USD 2.2 billion) respectively in 2004, still dominate banking, accounting for about 45 percent of all assets.

¶99. The financial profiles of both state banks have deteriorated over the years, mainly as a result of direct lending and operating inefficiencies. Since most of the bad debts of the two banks were implicitly guaranteed by the state, these problems did not affect the credibility of the banking system in Sri Lanka. The weaknesses in the state banks, however, make it possible for other inefficient banks to operate and for the more efficient banks to make higher profits than they would otherwise. The World Bank and IMF have identified the dominance of the inefficient state banks as a main constraint to developing the financial sector. The government re-capitalized the state banks during the 1990?s without success. The government has been trying to reorganize the banks. Top management at both Bank of Ceylon and People's Bank now contains private sector personnel, and the banks were granted

greater autonomy. Further, asset classification and provisioning norms have been progressively

strengthened. While Bank of Ceylon has met most of the restructuring targets and shows substantial improvements in its financial profile, the situation at People?s Bank remains weak. In particular, the provisioning has left the bank with a large negative equity affecting its operations. In addition, the failure to restructure large state owned utilities such as the Ceylon Electricity Board and the Ceylon Petroleum Corporation, and the failure to adjust prices in a timely manner, have recently forced these agencies to borrow from state banks, leading to a possible deterioration of asset quality in state banks.

¶100. In early 2005, the Cabinet approved new business development plans for the two state banks to make them more viable. The plans were developed under the guidance of the Strategic Enterprise Management Agency (SEMA), the high-powered restructuring agency of the Government. The plan for Bank of Ceylon aims to increase its profitability and efficiency. In the case of People?s Bank, the state is to re-capitalize the bank, for the third time, to meet a capital shortfall of Rs 10 billion. The latest capitalization is to be supported by an ADB program, which will include equity funding of about Rs 6 billion (USD 60 million) over 3 years. ADB funding will be required to meet performance targets on non-performing loans and demonstrate profitability, cost, and capital adequacy. The new plan signifies a departure from the earlier IMF agreed plan to sell the bank under a restructuring program.

--Private Commercial Banks and Foreign Banks

¶101. Private commercial banks and foreign banks operating in Sri Lanka generally follow more prudent credit policies and, as a group, are in better financial shape. Nonetheless, the private banking sector also remains trapped with a high level of non-performing loans, despite high margins. In 2004, the average rate of non-performing loans to total loans was 10 percent for domestic private banks and 14.2 percent for state banks. Foreign banks reported a much better ratio of 3.3 percent. There are concerns regarding inadequate loan loss provisioning and low operational efficiency in some local private banks. The banks are expected to improve provisioning with the introduction of new rules by the Central Bank in 2004. Foreign banks tend to make provisions in line with international best practices, as most foreign bank branches are subject to host country supervision in addition to that of the Central Bank of Sri Lanka. To help improve bank performance, an Asset Management Company Law is being prepared with World Bank and IMF assistance to provide troubled banks with a mechanism to effectively deal with their non-performing loans.

¶102. Credit ratings are mandatory for all banks operating in Sri Lanka from January 2004.

--Capital Adequacy

¶103. Sri Lanka adopted capital adequacy standards set by the Basel Committee on banking regulations and supervisory practices in 1993. In 2003, the Central Bank raised the minimum capital adequacy standards from 4.5 to 5 percent for core capital (Tier I) and from 9 to 10 percent for risk weighted assets (Tier I and Tier II). Further enhancing banking sector stability, the Central Bank has also imposed capital adequacy

standards on foreign currency banking units. In line with Basel Core Principles on effective banking supervision, compliance with Capital Adequacy on a consolidated basis was introduced in 2003.

¶104. People?s Bank currently does not meet Capital Adequacy Requirements (CAR), but it has a Ministry of Finance guarantee for funds required to meet its obligations. The ADB funded capital infusion is expected to help the bank meet its minimum capital requirements. Bank of Ceylon Tier I CAR was about 12.1 percent in 2003. Risk based capital adequacy at domestic commercial banks was 11.1 in 2004. CAR at foreign commercial Banks was 12.4 in 2004.

POLITICAL VIOLENCE

¶105. Since early 2002, there has been a marked improvement in the business climate due to the relatively peaceful atmosphere prevailing in the country. This is in contrast to the period between 1983-2001, when the country was plagued by ethnic conflict and related urban terrorism. The fighting between the Liberation Tigers of Tamil Eelam (LTTE) and the Sri Lankan military was primarily in northern and eastern Sri Lanka, but other parts of the country suffered sporadic terrorist attacks. Since 1997, the LTTE has been a US-designated Foreign Terrorist Organization (FTO). Terrorist activities of the LTTE declined since the LTTE and the Government signed a formal open-ended Cease-Fire Agreement in February ¶2002. Following six rounds of peace talks with the government of Norway acting as facilitator, the LTTE suspended its participation in the negotiations in April 2003.

¶106. Since April 2003, there have been numerous cease-fire violations, particularly in the eastern part of the country, primarily related to fighting between the LTTE and anti-LTTE Tamil groups, including a faction that split from the LTTE in 2004. Government of Sri Lanka intelligence officials, military and informants have also been targeted. In July 2004, a suicide bomb exploded in a Colombo police station following an assassination attempt against an anti-LTTE Tamil minister. Five people (including the bomber) were killed. In August 2005 suspected LTTE snipers shot and killed Foreign Minister Lakshman Kadirgamar at his Colombo residence. In December 2005 a Sri Lanka Navy bus was struck by an LTTE-command detonated mine, killing 13 soldiers?the highest number of casualties in a single incident since the beginning of the cease-fire in 2002. In January 2006, there were several additional troubling cease-fire violations, including the sinking of a Navy patrol boat, killing 13. The GSL and the LTTE have agreed to meet in Geneva in February 2006 to discuss ways to strengthen cease-fire implementation.

¶107. During almost 19 years of war, tourists and foreign business representatives have not been terrorist targets, but they have suffered collateral injuries during attacks on other targets. On July 24, 2001, the LTTE attacked the international airport and destroyed both commercial and military aircraft. Several military personnel were killed in the attack, military and airport employees were injured, and Sri Lankan civilians were caught in the crossfire. Sri Lankan Airlines, jointly owned by the Government of Sri Lanka and Emirates Airlines of Dubai, lost several

commercial aircraft in the attack. The LTTE has also attacked several commercial ships prior to 2001 flying foreign flags in the waters off the north and east of the country. In response to these attacks, insurers imposed war risk insurance surcharges on aircraft and ships using Sri Lankan seaports and airports. These

surcharges have been lifted since the cease-fire went into effect. During the conflict, the LTTE also detonated several large bombs in Colombo?s financial and business districts, causing numerous casualties and extensive damage to property. Very few foreigners were injured in these terrorist incidents due to the LTTE?s policy of targeting local interests.

CORRUPTION

¶108. The country has fairly adequate laws and regulations to combat corruption, but they are unevenly enforced. US firms identify corruption as a constraint on foreign investment, but, by and large, it is not a major threat to operating in Sri Lanka ? at least once a contract has been won. Corruption appears to have the greatest effect on investors in large projects as well as government procurement and tendering. According to Transparency International (TI), corruption is perceived as most pervasive in terms of political appointments to government institutions and in government procurement awards, as well as in high frequency/low value transactions. The police force and the judiciary are perceived to be the most corrupt public institutions. Corruption is also a persistent problem in customs clearance and enables wide-scale smuggling of certain consumer items, to the detriment of legitimate manufacturers and importers.

--The Bribery Commission is not very effective.

¶109. The Bribery Commission is the main body responsible for investigating allegations of bribery and corruption. The Commission?s most recent term expired in December 2004, and a new Commission was appointed after a 3-month delay in March 2005. The previous Commissions were not effective in dealing with bribery or corruption. The function of the Commission, under Act No 19 of 1994, is to investigate allegations brought to its attention and to institute proceedings against responsible individuals in the appropriate court. The law states that a public official?s offer or acceptance of a bribe constitutes a criminal offense and carries a maximum sentence of seven years imprisonment and a fine at the discretion of the courts. A bribe by a local company to a foreign official is not covered by the Bribery Act.

¶110. Few have been found guilty of corruption in recent years. Although highly publicized, efforts to investigate bribery and corruption have failed, damaging public confidence in such processes. While corruption charges have been leveled against politicians and top officials in charge of key government corporations, none of the accused has been convicted of bribery yet.

¶111. Sri Lanka ratified the UN Anti-corruption Convention in March 2004. Sri Lanka has signed but not ratified the UN Convention against Transnational Organized Crime. Sri Lanka is not a signatory to the OECD-ADB Anti-Corruption Regional Plan.

¶112. Transparency International (TI), an international "watchdog" organization promoting anti-corruption

strategies, runs a national chapter in Sri Lanka. In TI?s Corruption Perception Index for 2005, Sri Lanka was 78th among 158 countries with a score of 3.2 out of a clean score of 10, reflecting a relatively high perceived level of corruption among politicians and public officials. Sri Lanka?s corruption ranking and score deteriorated in 2005 from 67th and 3.5 respectively in 2004. TI?s 2003 National Integrity

Systems Country Report recommends creating an independent anti-corruption authority with sufficient powers as a top priority to combat corruption. TI has asked the international donor community to ensure transparency and clear lines of accountability in the disbursement of donor aid for post war reconstruction and post tsunami reconstruction. In response, the Government?s tsunami reconstruction agency (now known as Reconstruction and Development Agency (RADA) with the assistance of the United Nations (UN) has created a web based Development Assistance Database (DAD) (www.dad.tafren.gov.lk) for tracking information regarding tsunami aid disbursement and project implementation.

¶113. In terms of Economic Freedom, Sri Lanka is ranked 92 out of 157 countries in the Heritage Foundation?s 2006 Index of Economic Freedom. Countries receive a 1-5 rating - with one being the best - on 10 broad measures of economic freedom: trade policy, government fiscal burden, government intervention in the economy, monetary policy, foreign investment, banking and finance, wages and prices, property rights, regulation and informal market activity. Sri Lanka?s overall rating score worsened in 2006 to 3.19 from 3.03 in
¶2005.

BILATERAL INVESTMENT AGREEMENTS

¶114. The Government of Sri Lanka has signed Investment Protection Agreements with the United States (which came into force in May 1993) and the following countries:

¶1. Belgium
¶2. People?s Republic of China
¶3. Denmark
¶4. Egypt
¶5. Finland
¶6. France
¶7. Germany
¶8. Indonesia
¶9. India
¶10. Iran
¶11. Italy
¶12. Japan
¶13. Korea
¶14. Luxembourg
¶15. Malaysia
¶16. Netherlands
¶17. Norway
¶18. Romania
¶19. Singapore
¶20. Sweden
¶21. Switzerland
¶22. Thailand
¶23. United Kingdom

--Taxation

¶115. A bilateral treaty between Sri Lanka and the United States to avoid double taxation was ratified and entered into force on June 12, 2004.

¶116. Foreign investors not qualifying for Board of Investment incentives such as tax and exchange control exemptions or concessions are liable to pay taxes on corporate profits, dividends, and remittances of profits. They are also liable to pay a Value Added Tax on goods and services. The government has also imposed

a tax of 0.1 percent on debits to any current or savings account maintained at any bank in Sri Lanka. Debits made to accounts of government and international organizations are excluded. Accounts maintained at Foreign Currency Banking Units, accounts maintained for stock exchange transactions (SIERA), and resident and non-resident foreign currency accounts are exempted from the tax. The Embassy encourages prospective US investors to contact an international auditing firm operating in Sri Lanka to assess their tax liability.

OPIC AND OTHER INVESTMENT INSURANCE PROGRAMS

¶117. The US and Sri Lanka concluded in 1966 (and renewed in 1993) an agreement that allows the Overseas Private Investment Corporation (OPIC) to provide investment insurance guarantees for US investors. OPIC currently provides coverage to banking and power sector investments in Sri Lanka. Sri Lanka's membership in the Multilateral Investment Guarantee Agency (MIGA) offers the opportunity for insurance against non-commercial risks.

¶118. The US Embassy and other US Government institutions spend over USD 21 million annually in Sri Lanka. This amount can potentially be utilized by OPIC to honor an inconvertibility claim; however, no such claims have been made to date in Sri Lanka. The Embassy purchases local currency at the financial rate. The Sri Lankan Rupee has fluctuated against major foreign currencies during past 12 months. The currency is not expected to fluctuate by more than 10 percent relative to the US dollar over the next year.

LABOR

--Labor Force

¶119. Sri Lanka's labor force is literate (particularly in the local language) and trainable, although weak in certain technical skills and the English language. More computer and business skills training programs and English language programs are becoming available. But the demand for these skills still outpaces supply, and many qualified workers seek employment overseas. The average worker has eight years of schooling.

¶120. Two-thirds of the labor force is male. In the third quarter of 2004, the unemployment rate (employment is defined as one who worked for pay, profit, or unpaid family gain for one or more hours during the survey week) was 8.5 percent, or an estimated 678,600 of a total labor force of 8 million out of work. (Labor force data excludes some areas in the Northern Province, armed forces personnel deployed away from home, and Sri Lankan migrant workers abroad.) If one does not count unpaid family workers as employed, the unemployment rate is higher.

Underemployment is also a major problem, with thousands of university graduates seeking places in the already bloated public sector, yet lacking skills needed in the private sector. Youth and entry-level unemployment remains a critical problem. Nearly 80 percent of unemployed persons are in the 15-29 year age range. Over 50 percent of unemployed young people are educated at the Ordinary-Level (British System equivalent of US 10th grade) or higher.

¶121. A significant proportion of unemployed people seek "white collar" jobs, and most sectors seeking

employees offer manual or semi-skilled jobs or require technical or professional skills such as management, marketing, information technology, accountancy and finance, and the English language. Following pledges during April 2004 parliamentary elections and recently concluded Presidential elections, the government has initiated several programs to expand state sector employment. For instance, a graduate employment program provided about 42,000 new jobs in the government sector in 2005. A further 10,000 new jobs are to be created in 2006 and the Government has promised to hire into its bulging bureaucracy an additional 10,000 each year thereafter.

¶122. The government has recognized the challenge of reformulating the educational system to meet the needs of the private sector better, but it will take time before the mismatch of skills to requirements is addressed. USAID, the Asian Development Bank and the World Bank have recently approved projects to improve distance learning and tertiary education. The private sector is offering various professional study courses accredited to local and foreign professional institutes and foreign universities. However, access to these courses is limited due to the high fees involved. Additionally, a fair number of Sri Lankans study abroad.

--Migrant Workers Abroad

¶123. There are an estimated 970,000 Sri Lankan workers abroad. Remittances from migrant workers, at around $1.5 billion, is one of Sri Lanka?s largest sources of foreign exchange. The majority of this labor force is unskilled (housemaids and factory laborers) and located primarily in the Middle East. But Sri Lanka is also losing many of its technically and professionally qualified workers to more lucrative jobs abroad. The Government has pledged to promote programs aimed at increasing overseas employment opportunities for Sri Lankans.

--Low Cost of Labor; Fair to Growth-Limiting Labor Regulations

¶124. Labor is available at a relatively low cost, though it is priced higher than in other South Asian countries. Child labor is prohibited and is virtually nonexistent in the organized sector, although child labor occurs in informal sectors. The minimum legal age for employment is set at 14. Most permanent full-time workers are covered by laws pertaining to maximum hours of work, minimum wage, leave, the right of association, and safety and health standards. The Termination of Employment of Workmen Act (TEA) makes it difficult to fire or lay off workers who have been employed more than six months for any reason other than serious, well-documented disciplinary problems. Disputes over dismissals can be brought to a labor tribunal administered by the Ministry of Justice. The

labor tribunals have large backlogs of unresolved cases. Certain labor disputes founded upon fundamental rights (allegations of termination/transfers based upon discrimination, etc.) can be brought directly to the Supreme Court. Productivity lags behind other countries in Asia.

¶125. There is widespread belief that Sri Lanka?s labor laws and its plethora of holidays dampen productivity. The full moon day of each month (sacred in the Buddhist faith), if it falls on a weekday, is a paid holiday. There are also eight other public holidays. The public sector and banks enjoy additional holidays. These statutory holidays are in addition to 21 days of

annual/casual leave and approximately 21 days of sick leave (the number of days for sick leave is at the discretion of the management). Further, female employees are entitled to 84 days fully paid maternity leave for the first two pregnancies. The 2005 budget proposed additional maternity leave benefits, but they are yet to be implemented. Female workers are permitted 60 hours of overtime work per month.

¶126. The Government continues to interfere with private sector wage setting. In October 2005, the Government through an act of Parliament took steps to mandate a wage increase (of approximately Rs 1,000) to private sector workers. The private sector is concerned about such interference in wage setting, which could damage competitiveness in certain sectors.

--Termination laws

¶127. While the Termination of Employment of Workmen Act (TEA) described above makes it difficult to fire or lay off workers, Parliament, through the UNF government?s labor reform agenda, passed amendments in January 2003 to the TEA and the Industrial Disputes Act (IDA) to improve labor mobility. The amendments to TEA seek to facilitate termination and provide for a standard compensation formula and an unemployment benefit scheme. Amendments to the IDA include labor dispute resolution rules to expedite the dispute process. The new termination rules became operational with the establishment of a new compensation formula in March 2005. The compensation formula takes into account the number of years of service and offers 2.5 months salary as compensation for 1 year of service, 12.5 months salary for 5 years of service; 38 months for 20 years and up to a maximum of 48 months salary for 34 years service. This of course assumes that the government will approve such a termination, which frequently is not the case. The proposed unemployment benefit insurance scheme to provide an additional payment has not yet come into effect. According to a recent IMF report, Sri Lanka?s firing cost for 20 years of service, at 38 months, is among the highest in Asia compared with Pakistan and Nepal?s 22.5 months, India?s 19.6 months, Malaysia?s 18.5 months, China?s 13.2 months and Bangladesh?s 11.7 months. Under the new arrangements, the Labor Commissioner?s approval or the affected employee?s consent is required to fire workers. Employers complain that the package is excessive, especially compared to international norms. They have also pointed out that higher compensation could adversely affect companies requiring restructuring, and discourage investment.

¶128. Other planned reforms include amendments to the Shop and Office Act to allow female employees in the IT sector to work at night. A more systematic overhaul of the TEA and IDA would help to bring labor laws in line

with international norms.

--Trade Unions

¶129. About 15 percent of labor in the industry and service sector is unionized. Labor in free trade zone enterprises tends to be represented by non-union worker councils.

¶130. Unions have complained that the BOI and some employers, especially in the BOI-run export processing zones (EPZ), prohibit union access and do not register unions on a timely basis. Employers allege that the JVP, a Marxist political party against private ownership, could provoke labor to strike in the guise of trade union activity. Due to the JVP?s violent

past, employers are generally not in favor of it or its trade union arm, the Inter-Company Trade Union.

¶131. The Government continues to take steps to improve enforcement of labor regulations inside EPZs. In BOI enterprises, including those in the EPZs, worker councils composed of employees generally engage in labor and management negotiations. These worker councils have functioned well in some companies in providing for worker welfare. The BOI has requested that companies recognize trade unions and accept the right to collective bargaining. According to the BOI, where both a recognized trade union with bargaining power and a non-union worker council exist in an enterprise, the trade union will represent the employees in collective bargaining.

¶132. The ILO Freedom of Association Committee has observed that Sri Lankan trade unions and employee councils can co-exist, but advises that there should not be any discrimination against those employees choosing to join a union. The right of employee councils to engage in collective bargaining has been held as valid by the ILO. The ILO has, however, noted weaknesses in rules governing operation of employee councils and low prevalence of collective bargaining agreements and requested that the Government carry out improvements.

¶133. In response to these observations, the BOI revised its labor manual in March 2004, requesting that companies located in EPZs allow union access to zones and provide official time off to union members to attend meetings. Along with this revision, the BOI also issued new guidelines for the formation and operation of employee councils, giving powers to employee councils to negotiate binding collective agreements.

¶134. In 2002, the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO) submitted a petition to the United States Trade Representative seeking suspension of Generalized System of Preferences (GSP) benefits for Sri Lanka due to labor rights violations in some factories in the EPZs. This petition was not acted upon. A similar submission was made to the European Union (EU) by a local trade union when Sri Lanka applied for benefits under the special incentive arrangements of the GSP. After an audit, the EU, in January 2004, granted significant benefits to Sri Lanka under EU GSP in recognition of the country?s efforts to implement core labor standards because the audit did not find serious problems with regard to those standards. The EU, however, observed the need for further improvements in freedom of association.

¶135. In the plantation sector, union participation rates are as high as 75 percent, though unionization levels are reportedly on the decline. Key public sector entities such as the Ceylon Electricity Board and Sri Lanka Ports Authority also have large unions which stage protests, often to obtain pay hikes and sometimes to protest anticipated moves towards privatization or restructuring. Most of the major trade unions are affiliated with political parties, creating a highly politicized labor environment. Several trade unions with affiliations to major political parties have formed themselves into an organized group, the National Association for Trade Union Research and Education (NATURE), to promote education and training among trade unionists.

¶136. The growing strength of Marxist parties in active

politics and in parliament has increased politicized union activity, especially in government institutions. State agencies with large unionized workforces have become vulnerable to politically motivated strikes in response to restructuring and privatization.

--Collective Bargaining

¶137. Collective bargaining is not yet popular. While more than half of the Employers? Federation of Ceylon?s (EFC?s) 435-strong membership is unionized, currently only about 50 of these companies (including a number of foreign-owned firms) have collective agreements and use them to conduct negotiations on their behalf. Civil servants other than officers in the police, armed forces, and prison service, also have a right to strike.

--Labor-Management Relations

¶138. Labor-management relations in the past have typically been confrontational. The attitude of employers towards workers has changed considerably in the last few years. Employers are becoming more conscious of the need to look after their human resources, and more effort is taken to ensure that workers feel motivated and cared for. While labor-management relations vary from organization to organization, managers who emphasize communication with workers and offer training opportunities generally experience fewer difficulties. US investors in Sri Lanka (including US garment buyers) generally promote good labor management relations and labor conditions that exceed local standards. Work stoppages and strikes in the private sector are on the decline.

--ILO conventions

¶139. Sri Lanka is a member of the International Labor Organization (ILO) and has ratified 39 international labor conventions. The labor laws of Sri Lanka are laid out in almost 50 different statutes. The Ministry of Labor has published a Labor Code, consolidating important labor legislation. Sri Lanka has ratified all eight of the core labor conventions included in the 1998 ILO Declaration on Fundamental Principles and Rights at Work. ILO Convention 138 on minimum age for admission to employment and Convention 182 on worst forms of child labor were ratified during 2000-2001. Sri Lanka ratified ILO convention 105 on Forced Labor in 2003. The ILO, EFC and the AFL-CIO-sponsored American Center for Labor Solidarity are working to improve awareness about core labor standards. The ILO also promotes its Decent Work Agenda program in Sri

Lanka.

FOREIGN TRADE ZONES

¶140. Sri Lanka has 10 free trade zones, also called export-processing zones, administered by the BOI. The oldest, the Katunayake and Biyagama Zones, located north of Colombo near the Bandaranaike International Airport, are fully occupied. The third zone is located at Koggala on the southern coast. Several new mini export-processing zones were opened in the provinces during the last few years. There are nearly 200 foreign export processing enterprises operating in these zones. There are also two industrial parks that have both export-oriented and non-export oriented factories. They are located in Pallekelle, near Kandy in central Sri Lanka and in Seethawaka in Avissawela about 60 kilometers from Colombo.

¶141. In the past, industrialists preferred to locate their factories in close proximity to Colombo harbor or airport to reduce transport cost and save time. The excessive concentration of industries around Colombo has created problems such as scarcity of labor, inadequate infrastructure, environmental pollution, escalation of real estate prices, and congestion in the city. The BOI actively encourages the establishment of export-oriented factories in the newly developed industrial zones. The BOI also finds it easier to provide infrastructure facilities and security, as well as to monitor enterprises, when they are located in the zones. However, the limitations of transportation infrastructure may make some distant zones somewhat less appealing.

FOREIGN DIRECT INVESTMENT

--US Investments

¶142. Major US companies with investments in Sri Lanka include: Energizer Battery, Mast Industries, Smart Shirts (a subsidiary of Kellwood Industries), Chevron, Citibank, Caterpillar, 3M, Cargill, Coca Cola, Celetronix, Inc, Paxar Corporation, Pepsi Co, Sportif, Worldquest, Fitch IBCR, AES Corporation, American International Group (AIG), American Premium Water, Virtusa, Avery Denison, North Sails, and Amsafe Bridport. In addition, IBM, Lanier, NCR, GTE, Motorola, Procter & Gamble, Liz Claiborne, Tommy Hilfiger, J.C. Penney, the Gap, Sun Microsystems, Microsoft, Bates Strategic Alliance, McCann-Erickson, Pricewaterhouse Coopers, Ernst and Young, and KPMG all have branches, affiliated offices or local distributors/representatives. Kentucky Fried Chicken, Pizza Hut, Federal Express, UPS, and McDonald?s are represented in Sri Lanka through franchises. Numerous other American brands and products are represented by local agents.

¶143. US investment in Sri Lanka is estimated to be in the range of USD 200 million. A recent investor in the power sector is AES Corporation. AIG insurance entered Sri Lanka in 1999. Other foreign companies in Sri Lanka are expanding, such as Celetronix Inc (memory boards), Virtusa and Citibank. During the past few years, several US companies have formed joint ventures or other partnerships with Sri Lankan companies in the IT sector, mainly in software development.

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--Non-US Investments

¶144. Major non-US investors include: Unilever, Nestle, British American Tobacco Company, Mitsui, Pacific Dunlop/Ansell, Prima, FDK, Telekom Malaysia Bhd, S.P. Tao and HSBC. Leading US and foreign investors that have acquired significant stakes in privatized companies include Chevron, Norsk Hydro of Norway, Hanjung Steel of Korea, Nippon Telephone and Telegraph, Mitsubishi Corporation and C. Itoh (A.K.A. Itochu) of Japan, Emirates Airlines of United Arab Emirates, Shell Oil of the UK, P&O Netherlands, and the Indian Oil Corporation (IOC)

¶145. Reliable statistics on foreign investment by country are not available. Leading sources of foreign investments are Singapore, United Kingdom, Japan, South Korea, Hong Kong, and Australia. FDI in 2005 was about USD 150 million.

¶146. Note: 2005 data are estimates.